RD AN No.4411 (1980-D)
December 3, 2008

TO: All State Directors
Rural Development

ATTENTION: Rural Housing Program Directors,
Guaranteed Rural Housing Specialists,
Area Directors and Area Specialists

FROM: Russell T. Davis ***(Signed Russell T. Davis)***
Administrator
Housing and Community Facilities Programs

SUBJECT: Single Family Housing Guaranteed Loan Program
Adequate and Dependable Income - Rents or Leases

PURPOSE/INTENDED OUTCOME:

The purpose of this Administrative Notice (AN) is to clarify how to treat residential rental income when underwriting loans under the Single Family Housing Guaranteed Loan Program (SFHGLP) when there is a newly signed lease for a property which a borrower will not sell when purchasing a new principal residence.

COMPARISON WITH PREVIOUS AN:

There is no previous AN issued on this subject.

EXPIRATION DATE:
December 31, 2009

FILING INSTRUCTIONS:
Preceding RD Instruction 1980-D

BACKGROUND:

The SFHGLP continues to evaluate both the real estate lending environment and loan performance. Federal Housing Administration (FHA) released Mortgagee Letter (ML) 2008-25 on September 19, 2008, in response to an unscrupulous practice arising in the mortgage market that poses a risk not only to FHA, but also to the SFHGLP portfolio and approved lenders. The practice is known in the mortgage industry as "buy and bail."

An increasing number of homeowners are attempting to purchase new homes but cannot sell their existing principal dwellings because of prevailing market conditions. Some homeowners are attempting to retain and rent out their existing principal residence, while at the same time trying to purchase a new principal residence. The homeowners attempting to rent out their existing properties are producing newly signed leases as evidence of income to offset the costs of maintaining the old residence and continue making payments on it. Increasingly, income from the new leases never materializes and the old principal residence goes into foreclosure.

IMPLEMENTATION RESPONSIBILITIES:

RD Instruction 1980-D, Section 1980.345(c)(2)(i) states, "the lender must determine whether there is a historical basis to conclude that the income is likely to continue when determining income utilized in debt ratio calculations."

Newly signed leases:

A newly signed lease has no historical basis to conclude that the income is likely to continue. Applicants who wish to purchase a new principal residence and retain or rent a residence must qualify with all mortgage liability payments. Income from newly signed leases cannot be used in debt ratio calculations. The exclusion of rental income will ensure the applicant has sufficient monthly income to meet all mortgage and liability payments. This applies to manual and automated underwritten loan files.

Rental income that is not stable and dependable should not be included in either repayment or annual income calculations for program eligibility.

This guidance, similar to the FHA guidance in Mortgagee Letter 2008-25, is provided in an effort to prevent "buy and bail" scenarios as described in the "background" section above. While the property being vacated may not have a mortgage guaranteed by USDA Rural Development, surrounding properties may, and therefore USDA Rural Development could be negatively impacted as the result of a foreclosure.

Exception:

RD Instruction 1980-D, section 1980.346(a) indicates that he applicant must be a person who:

1. does not own a dwelling in the local commuting area.
2. owns a dwelling which is not structurally sound, functionally adequate.

Example: If an individual or family has been transferred or found employment in a different state, and their old residence is not in the local commuting area of their new employment location, they meet the requirement of not owning a dwelling in the local commuting area.

Example: If the home has documented structure, safety, or sanitation issues, or if it is a manufactured home not anchored on a permanent foundation, it would not be considered structurally sound or functionally adequate.

The instances covered in sections 1980.346(a)(1) and (2) are the only instances in which applicants may retain their old residence and for which newly signed leases may be considered. In these cases, the lender may consider an executed lease agreement signed by both parties along with proof that the security deposit and the first months rent have been paid. The gross monthly rent amount must be reduced for maintenance and as a vacancy factor by 25 percent before subtracting principal, interest, taxes, and insurance (PITI), homeowners' association dues, and any other recurring housing expenses. The remainder must be applied to income, or treated as a recurring debt if negative.

Example: Assume a monthly rent income of $500, and a PITI of $400. The net rent income after a 25 percent reduction is $375. After subtracting the PITI, the applicant will have a $25 monthly debt associated with the rental property.

Example: If the monthly rent income were $600 and the PITI is $400, the net rent income after the 25 percent reduction would come to $450, and subtracting the PITI would result in monthly income of $50.

Historically leased properties and Federal Tax Returns:

Other than the newly signed lease scenarios discussed above under sections 1980.346(a)(1) and (2), it is possible that an applicant has a history of receiving rents from a leased property. If an applicant has historically leased a property, the lender may be able to use the applicant's tax returns to document the rental income as "adequate and dependable."

Rents received by the applicant over the past 24 month period should be documented on IRS Form 1040, Schedule E, for the past 2 income tax filings. The income may be averaged over the past 24 month period, and depreciation may be added back to the net income or loss shown on Schedule E. Positive rental income may be considered as gross income for qualifying purposes. Negative rental income or cash flow must be treated as a recurring monthly liability.

Income Eligibility

If there is income calculated, either from the tax return or from the lease scenarios, it should be included in income eligibility calculations as well as repayment income calculations.

Questions regarding this AN may be directed to Kristina Zehr (309) 452-0830 ext. 111, or Joaquin Tremols at (202) 720-1465. Their respective email addresses are kristina.zehr@wdc.usda.gov and joaquin.tremols@wdc.usda.gov.